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SUBJECT: WORLD BANK/IFC'S CHENGDU OFFICIALS ON STRUCTURAL IMPEDIMENTS
TO SME- AND MICRO-FINANCING

REF: BEIJING 2952

CHENGDU 00000272 001.2 OF 004

¶1. (U) This cable contains sensitive but unclassified information - not for distribution on the Internet.

¶2. (SBU) Summary: Small business access to credit in China is a long-term, structural problem that 'is not going away for the next 10-20 years", a Chengdu-based official of the World Bank's International Finance Corporation (IFC) told Consul General. While official statistics indicate increased small and medium enterprise (SME) financing in 2009, this has gone primarily to the "medium" end of the spectrum, with true small and micro ventures remaining significantly underserved. The development of a healthy, non-deposit taking lending institution (NDTL) sector, requiring significant financial sector liberalization, is the key long-term solution, he said. Newly-emerging local credit guarantee companies (CGS) could evolve into an important component of the sector, if allowed to start legally lending. He also advocated increased government support for rural SME credit, particularly through "value chain financing," a new approach IFC is promoting in China. End Summary.

IFC on Goals and Activities
in Southwest China; Optimism About Chongqing

¶3. (SBU) In a November 10 meeting with Consul General, Lai Jinchang, head of IFC's Chengdu office, discussed:

-- the challenges China faces in providing sufficient credit to small and micro-enterprises;
-- the particular challenges of addressing rural credit access; and,
-- how IFC is working to address these issues.

Also in the meeting were Charlie Cheng, Program Manager for Corporate Advice-Sustainability and Lin Huang, Operations Officer. The IFC's Chengdu office was created in 2001, at the request of the Chinese Government, following the launching of the PRC's "Go West" policy on January 1, 2000. Although its emphasis is on western China, the IFC Chengdu office coordinates with the Beijing and Ulaanbaatar offices on IFC's overall China/Mongolia programs.

¶4. (U) IFC Chengdu primarily focuses on technical advising services, but also has two investment officers and has coordinated IFC investment in:

-- Renshou Minfu Rural Bank, a village and township bank (VTB) an initiative by the Leshan City Commercial Bank, in Sichuan province, to promote micro-finance; and,

-- the Chengdu Small Enterprise Credit Guarantee Company, which guarantees loans to SMEs by local credit cooperatives and commercial banks.

The office is working to help create and invest in additional microfinance institutions throughout Southwest China, including in Guizhou, Yunnan, and Chongqing (as well as Xinjiang). (Note: IFC investments are limited to a maximum of 20 percent of a target institution, Lai said. End Note.)

¶5. (SBU) Lai expressed particular optimism about Chongqing, reporting that Mayor Wang Hongju "has been very open-minded" and expressed to IFC that he wants a micro-credit company in each of its 40 counties and districts. (Note: We understand that about four have been established there within the last year. End Note.) However, the IFC has no activities in the Tibetan Autonomous Region (TAR) -- they "can't touch" it, noted Lai, as it is "too sensitive." (Note: According to local TAR officials China provides microfinance in the TAR via its "Developing Border Areas and Enriching People" (xingbian fumin) initiative, which officially covers the entire autonomous region. They cited as an example the state-owned Agricultural Bank of China's micro-finance subsidiary (xinyongshe) in the TAR, which provides micro-credit to farmers and herders (nongmumin). End Note.)

IFC Official: SME Credit Access a Long-Term Structural Challenge
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¶6. (SBU) In Lai's assessment, substantive expansion of credit access to China's SMEs is fundamentally impeded by long-term structural challenges, specifically the lack of a developed non-deposit taking lender (NDTL) sector. This fundamental problem, he said, is 'not going away for the next 10-20 years." The lack of NDTLs stems from an underdeveloped capital market, and cannot be addressed without true, long-term liberalization of the financial sector, he said. Lai estimates that 90-95 percent of debt financing in China currently comes from

deposit-taking institutions (banks), in contrast to his estimate of bank finance comprising no more than 60 percent of the total in the United States. Chinese banks, he asserted will remain, both by regulation and necessity, conservative (policy-lending) institutions that will continue to loan primarily to the larger end of the business spectrum. (Comment: Lai's emphasis on the financial sector's structure as the primary issue adds to the barriers to SME credit that others have told us about, including the banks' lack of familiarity with SMEs and a consequent inability to properly assess risk; lack of effective rule of law to enforce contracts; and corruption and nepotism. End Comment.)

¶7. (SBU) Acknowledging recent official emphasis on expanding SME credit (such as the State Council's September directive to bolster SMEs), and recent statistics citing an increase in SME lending in 2009 supported by the stimulus package, Lai argued that the vast majority of this lending is going to the medium end of the SME scale, leaving out most truly small businesses. There is widespread misapplication of the "micro," "small," and "medium" labels throughout China, he argued. In his view the business lending market should be analytically divided up into five categories of enterprises: a) micro, b) micro - small, c) small, d) medium, and e) large corporations. (Note: He did not provide a hard definition of each category in regards to either number of employees or level of assets. End Note.) The real challenge to accessing credit falls within the first three categories, he noted. Thus, he said, too often when "SMEs" are said to be benefiting from increased access to credit, the funds are mostly flowing to medium-sized enterprises, or at best the very top end of the small business market. Almost all micro and most small enterprises have seen no genuine expansion in credit access, Lai asserted.

Few "Microfinance" Institutions Actually Providing Microfinance
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¶8. (SBU) Lai noted that officially there are three types of

financial institutions in China that are supposed to be providing micro credit, including:

-- banks that are downscaling to provide a "micro" product;
-- the village and township banks (VTBs), piloted under the Banking and Regulatory Commission; and,
-- micro-credit corporations (MCCs), non-deposit taking institutions piloted under the People's Bank of China.

However, of the 1000 MCCs and 110 VTBs he estimates have been established nationwide, he believes that most -- "practically all" -- do not actually do microfinance. Typical loans of these institutions, he said, rarely fall below 2 - 3 million RMB (approximately 295,000 - 440,000 USD). He cited IFC-supported institutions, by contrast, as an exception, asserting that they are doing "real" microfinance, although he did not specify the loan amounts they were dispersing. (Note: Some international NGOs in Southwest China, such as the Nature Conservancy and the Mountain Institute, are also providing microfinance. End note.)

¶9. (SBU) Lai was generally pessimistic about the ability of major Chinese commercial banks to service the lower end of the SME spectrum in Southwest China. Citing the case of Minsheng Bank, which established a "small enterprise" financing capacity at its Chengdu branch several years ago, he emphasized that they will "never do micro-credit," and that "the actual size of Minsheng's loans is much larger than the IFC considers to be microfinance."

¶10. (SBU) Lai also dismissed the notion that foreign banks might establish a significant presence in the microfinance field, noting that they in fact have little interest in institutions such as the VTBs. Those that have invested in VTBs (e.g. HSBC, Standard Chartered) or established microfinance units (e.g. Citibank) have done so in response to government pressure, rather than because of a belief in the potential profitability of the microfinance sector. Thus, for example, Citibank's microfinance unit is, in reality, a part of their corporate social responsibility (CSR) function, rather than a genuine business line. In this vein, he cited misunderstandings regarding the nature of microfinance by many government officials, who, he said, fail to understand that microfinance is normally not the purview of traditional financial institutions. Microfinance, he concluded, is overall a "very new concept for China."

Where Do Small Businesses in Southwest China Turn for Credit?
Enter the Credit Guarantee Company
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¶11. (SBU) Given Lai's assessment that even banks that are downscaling are only reaching the top of the small business market, CG asked where the remaining established small businesses in Southwest China could turn for credit. Lai responded that most micro-to-small enterprises have very limited choices, and generally must pay considerably higher interest rates. Many go to "pawn shops" (diandanghang), which he described as serving a very different function than US pawn shops. Rather than serving as a lender of last resort, they provide an accessible -- if high interest -- option for small business financing upon the provision of tangible collateral (ranging from physical property to property deeds or stock certificates). An increasing number of small ventures, however, are now obtaining "under the table loans" from the growing number of credit guarantee companies (CGCs), he said.

¶12. (SBU) Lai described the CGCs as a relatively new/emerging financial institution, still facing considerable controversy regarding their appropriate role and structure. Noting that the national regulatory framework governing CGCs was only established in February of 2009 with creation of the Inter-Ministerial Committee on CGCs within the CBRC, he assessed it as "not a strong system," remaining basically a locally run initiative. Though relatively lightly regulated, CGCs are

supposed to limit their activities to guaranteeing other institutions' loans and are statutorily barred from making loans themselves. However, despite their lack of lending license, many in Southwest China have money to lend, he said, and are finding ways to lend to small businesses. (Lai estimates Chengdu to be home to about 100, out of a total of about 4,000 nationwide.) Their investors are often wealthy entrepreneurs with plenty of spare cash seeking an alternative to either volatile stock investments, or low-interest bank accounts. They see CGCs as a way to both diversify investments and get their foot in the door of the financial market, he said, which they hope will be highly profitable after future liberalization.

The Long-Term Solution:
Liberalize the Financial Sector, Let CGCs operate as NDTLs
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¶13. (SBU) Despite some positive evolutions in institutional arrangements and the expansion of under the table CGC loans, Lai concluded that the current regulatory system will simply not allow sufficient flexibility to ensure that credit can reach far enough into the small enterprise world. Much greater liberalization of the market is necessary, he insisted, otherwise the regulatory environment will continue to constrain the vast majority of would-be entrants to the SME financing market. A key goal of liberalization, he emphasized, should be the large-scale expansion of the NDTL sector, which he described as currently "rudimentary," comprising only the MCCs, CGCs, and pawn shops discussed above. What is lacking in this picture, he said, is the wide range of NDTLs recognized worldwide by the IFC, such as university endowments, foundations, pension funds, student loan corporations, etc., all of which could step into the riskier credit provision arenas.

¶14. (SBU) CGCs in particular have the potential to take on a significant role as NDTLs if they are allowed to start loaning legally. However, many CGC investors are expecting to be able to turn them into deposit-taking banks, reflecting a fundamental misunderstanding of the role and function of banks, Lai asserted. "They will not be allowed to become banks for very good reasons," he said, noting the need to shield depositors from riskier use of their funds (e.g. through fiduciary rules and capital adequacy ratios). He said that most officials and regulators lack understanding of the distinct roles of banks versus NDTLs, something he says IFC is attempting to remedy.

Rural Financing: The Value Chain Approach

¶15. (SBU) In contrast to his case for decreased regulation in the financial sector overall, Lai argued that expanding rural credit access requires significantly greater government intervention due to the inherent risks involved (e.g., weather, commodity prices, land title issues), and stressed that China is far behind both the U.S. and Europe in terms of government involvement in rural financing. Beyond the expansion of micro and SME finance, he said the IFC is now promoting a "value chain" approach to rural credit expansion, aiming to structure financial services to simultaneously address the needs of small-scale farmer/producers, suppliers (e.g. of agricultural inputs), and other agribusinesses (processors and distributors of agricultural production).

¶16. (SBU) A key example he cited for this model is the Chengdu-based New Hope Group which, he reported, is creating a number of CGCs solely for the purpose of providing loan guarantees for banks and rural credit cooperatives to loan to SMEs within the New Hope supply chain. Lai noted that this allows new SME start ups in rural areas, while enabling New Hope to develop markets for their own products and stabilizing their supply. For example, in Mianyang (Sichuan's second largest city, north of Chengdu), a New Hope CGC is guaranteeing the loans made by banks to pig farmers, who in turn purchase New Hope's pig feed, and then sell their wholesale pork products to

New Hope. New Hope is also providing some additional services through the CGC structure, such as free veterinary services to pig farmers in their supply chain. Lai Qid that these types of CGCs are increasingly able to obtain a range of government subsidies when registering. That said, the value-chain financing model remains a new concept within the IFC, globally as well as within China.
BROWN